

WORLDCOM, INC.

**SCHEDULE II
VALUATION AND QUALIFYING ACCOUNTS**

<u>Descriptions</u>	<u>Balance at Beginning of Period</u>	<u>Deconsolidation of Embratel</u>	<u>Charged To Costs and Expenses</u>	<u>Additions From Purchase Transactions</u>	<u>Deductions and Accounts Written Off</u>	<u>Balance at End of Period</u>
Allowance for doubtful accounts (in millions):						
Accounts Receivable						
2001	\$1,532	\$282	\$1,313	\$194	\$1,671	\$1,086
2000	1,122	—	1,865	—	1,455	1,532
1999	920	—	951	19	768	1,122

INDEX TO FINANCIAL STATEMENTS

	<u>Page</u>
Worldcom Group (an integrated business of Worldcom, Inc.)	
Report of independent public accountants	F-50
Combined balance sheets as of December 31, 2000 and 2001.	F-51
Combined statements of operations for the three years ended December 31, 2001	F-52
Combined statements of allocated net worth for the three years ended December 31, 2001 ...	F-53
Combined statements of cash flows for the three years ended December 31, 2001	F-54
Notes to combined financial statements	F-55

You should understand the following when reading the combined financial statements of the WorldCom group, which is an integrated business of WorldCom, Inc.:

- WorldCom has presented the combined financial statements of the WorldCom group at substantially the same level of detail as the consolidated financial statements of WorldCom. WorldCom believes that investors require detailed financial information for the WorldCom group to properly evaluate the market potential of WorldCom group stock;
- the WorldCom group is a collection of WorldCom's data, Internet, international and commercial voice businesses and is not a separate legal entity;
- the holders of the WorldCom group stock are shareholders of WorldCom and do not have an ownership interest in the WorldCom group or any company in the WorldCom group or a claim on any of the assets attributed to the WorldCom group;
- the attribution of a portion of WorldCom's assets and liabilities to the WorldCom group does not affect WorldCom's ownership of these assets or responsibility for these liabilities and does not affect the rights of any creditor of WorldCom; and
- the assets attributed to the WorldCom group could be subject to the liabilities attributed to the MCI group.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Shareholders of WorldCom, Inc.:

We have audited the accompanying combined balance sheets of the WorldCom group (an integrated business of WorldCom, Inc.) (as described in Note 1) as of December 31, 2000 and 2001, and the related combined statements of operations, allocated net worth and cash flows for each of the years in the three-year period ended December 31, 2001. These financial statements are the responsibility of WorldCom, Inc.'s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. **An** audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. **An** audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the WorldCom group combined financial statements referred to above present fairly, in all material respects, the combined financial position of the WorldCom group as of December 31, 2000 and 2001, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1 to the combined financial statements, effective January 1, 2000, the WorldCom group changed its method of accounting for certain activation and installation fee revenues and expenses.

The WorldCom group is a fully integrated business of WorldCom, Inc. Accordingly, as described in Note 1, the WorldCom group's combined financial statements have been derived from the consolidated financial statements and accounting records of WorldCom, Inc. and, therefore, reflect certain assumptions and allocations. **As** more fully discussed in Note 1, the combined financial statements of the WorldCom group should be read in conjunction with the audited consolidated statements of WorldCom, Inc.

ARTHUR ANDERSEN LLP

Jackson, Mississippi
March 7, 2002

WORLDCOM GROUP (an integrated business of WorldCom, Inc.)
COMBINED BALANCE SHEETS
(In Millions)

	<u>December 31,</u>	
	<u>2000</u>	<u>2001</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 720	\$ 1,409
Accounts receivable, net of allowance for bad debts of \$1,018 in 2000 and \$693 in 2001	4,980	3,734
Deferred tax asset	131	241
Other current assets	1,612	1,895
Receivable from MCI group, net	649	900
Total current assets	<u>8,092</u>	<u>8,179</u>
Property and equipment:		
Transmission equipment	19,883	23,369
Communications equipment	5,873	5,434
Furniture, fixtures and other	8,666	10,583
Construction in progress	6,727	5,576
	<u>41,149</u>	<u>44,962</u>
Accumulated depreciation	<u>(5,972)</u>	<u>(8,170)</u>
	<u>35,177</u>	<u>36,792</u>
Goodwill and other intangible assets	36,685	40,818
Long-term receivable from MCI group, net	976	976
Other assets	4,963	5,136
	<u>\$85,893</u>	<u>\$91,901</u>
LIABILITIES AND SHAREHOLDERS' INVESTMENT		
Current liabilities:		
Short-term debt and current maturities of long-term debt	\$ 7,200	\$ 172
Accrued interest	338	507
Accounts payable and accrued line costs	3,584	2,751
Other current liabilities	3,091	2,485
Total current liabilities	<u>14,213</u>	<u>5,915</u>
Long-term liabilities, less current portion:		
Long-term debt	11,696	24,533
Deferred tax liability	2,683	3,196
Other liabilities	965	546
Total long-term liabilities	<u>15,344</u>	<u>28,275</u>
Commitments and contingencies		
Minority interests	2,592	101
Company obligated mandatorily redeemable and other preferred securities	798	1,993
Allocated net worth	52,946	55,617
	<u>\$85,893</u>	<u>\$91,901</u>

The accompanying notes are an integral part of these combined statements.

WORLDCOM GROUP (an integrated business of WorldCom, Inc.)
COMBINED STATEMENTS OF OPERATIONS
(In Millions)

	For the Years Ended December 31,		
	1999	2000	2001
Revenues	\$19,736	\$22,755	\$21,348
Operating expenses:			
Line costs	7,905	8,745	8,120
Selling, general and administrative	4,195	5,689	6,058
Depreciation and amortization	3,013	3,280	4,121
Other charges	(8)	—	—
Total	15,105	17,714	18,299
Operating income	4,631	5,041	3,049
Other income (expense):			
interest expense	(460)	(458)	(1,029)
Miscellaneous	237	385	412
Income before income taxes, minority interests and cumulative effect of accounting change	4,408	4,968	2,432
Provision for income taxes	1,856	1,990	943
Income before minority interests and cumulative effect of accounting change	2,552	2,978	1,489
Minority interests	(186)	(305)	35
income before cumulative effect of accounting change	2,366	2,673	1,524
Cumulative effect of accounting change (net of income tax of \$43 in 2000)	—	(75)	—
Net income before distributions on mandatorily redeemable preferred securities	2,366	2,598	1,524
Distributions on mandatorily redeemable preferred securities and other preferred dividend requirements	72	65	117
Net income	\$ 2,294	\$ 2,533	\$ 1,407

The accompanying notes are an integral part of these combined statements.

WORLDCOM GROUP (an integrated business of WorldCom, Inc.)
COMBINED STATEMENTS OF ALLOCATED NET WORTH
For the Three Years Ended December 31, 2001
(In Millions)

	Attributed Capital	Unrealized Holding Gain (Loss)	Foreign Currency Translation Adjustment	Allocated Net Worth
Balances, December 31, 1998	\$42,197	\$ 122	\$ (28)	\$42,291
Funds attributed from WorldCom, Inc.	1,935	—	—	1,935
Advances from MCI group, net.	2,097	—	—	2,097
Other comprehensive income (net of taxes and reclassifications):				
Net income before distributions on mandatorily redeemable preferred securities	2,366	—	—	2,366
Distributions on mandatorily redeemable preferred securities and other preferred dividend requirements	(72)	—	—	(72)
Net change in unrealized holding gain on marketable equity securities	—	453	—	453
Foreign currency adjustment	—	—	(332)	(332)
Total comprehensive income				2,415
Balances, December 31, 1999	48,523	575	(360)	48,738
Funds attributed from WorldCom, Inc.	770	—	—	770
Advances from MCI group, net.	1,592	—	—	1,592
Other comprehensive income (net of taxes and reclassifications):				
Net income before distributions on mandatorily redeemable preferred securities	2,598	—	—	2,598
Distributions on mandatorily redeemable preferred securities and other preferred dividend requirements	(65)	—	—	(65)
Net change in unrealized holding gain on marketable equity securities	—	(230)	—	(230)
Foreign currency adjustment	—	—	(457)	(457)
Total comprehensive income				1,846
Balances, December 31, 2000	53,418	345	(817)	52,946
Deconsolidation of Embratel	(2)	—	335	333
Funds attributed from WorldCom, Inc.	1,422	—	—	1,422
Advances to MCI group, net	(15)	—	—	(15)
Other comprehensive income (net of taxes and reclassifications):				
Net income before distributions on mandatorily redeemable preferred securities	1,524	—	—	1,524
Distributions on mandatorily redeemable preferred securities and other preferred dividend requirements	(117)	—	—	(117)
Derivative financial instruments:				
Cumulative effect of adoption of SFAS 133 as of January 1, 2001	—	28	—	28
Reclassification of derivative financial instruments to current earnings	—	(110)	—	(110)
Change in fair value of derivative financial instruments	—	82	—	82
Net change in unrealized holding gain (loss) on marketable equity securities	—	(396)	—	(396)
Foreign currency adjustment	—	—	(80)	(80)
Total comprehensive income				931
Balances, December 31, 2001	<u>\$56,230</u>	<u>\$ (51)</u>	<u>\$(562)</u>	<u>\$55,617</u>

The accompanying notes are an integral part of these combined statements.

WORLDCOM GROUP (an integrated business of WorldCom, Inc.)
COMBINED STATEMENTS OF CASH FLOWS
(In Millions)

	For the Years Ended December 31,		
	1999	2000	2001
Cash flows from operating activities:			
Net income before distributions on mandatorily redeemable preferred securities.	\$ 2,366	\$ 2,598	\$ 1,524
Adjustments to reconcile net income before distributions on mandatorily redeemable preferred securities to net cash provided by operating activities:			
Cumulative effect of accounting change	—	75	—
Minority interests	186	305	(35)
In-process research and development and other charges	(8)	—	—
Depreciation and amortization	3,013	3,280	4,121
Provision for deferred income taxes	2,510	1,410	1,131
Change in assets and liabilities, net of effect of business combinations:			
Accounts receivable, net	(611)	(1,300)	104
Receivable from MCI group, net	(555)	(649)	(251)
Accounts payable and other current liabilities	746	624	(200)
Other current assets	119	(582)	104
All other operating activities	(414)	(431)	107
Net cash provided by operating activities	<u>7,352</u>	<u>5,330</u>	<u>6,605</u>
Cash flows from investing activities:			
Capital expenditures	(7,929)	(10,984)	(7,619)
Acquisitions and related costs	(786)	(14)	(206)
Increase in intangible assets	(389)	(771)	(367)
Decrease in other liabilities	(565)	(823)	(351)
All other investing activities	1,624	(1,020)	(275)
Net cash used in investing activities	<u>(8,045)</u>	<u>(13,612)</u>	<u>(8,818)</u>
Cash flows from financing activities:			
Principal borrowings (repayments) on debt, net	(2,894)	6,377	3,526
Attributed stock activity of WorldCom, Inc.	886	585	124
Distributions on mandatorily redeemable and other preferred securities and dividends paid on other equity securities	(72)	(65)	(83)
Redemptions of preferred stock	—	(190)	(200)
Advances (to) from MCI group, net	2,097	1,592	(15)
All other financing activities	—	(84)	(272)
Net cash provided by financing activities	<u>17</u>	<u>8,215</u>	<u>3,080</u>
Effect of exchange rate changes on cash	<u>(221)</u>	<u>(19)</u>	<u>38</u>
Net increase (decrease) in cash and cash equivalents	(897)	(86)	905
Cash and cash equivalents at beginning of period	1,703	806	720
Deconsolidation of Embratel	—	—	(216)
Cash and cash equivalents at end of period	<u>\$ 806</u>	<u>\$ 720</u>	<u>\$ 1,409</u>

The accompanying notes are an integral part of these combined statements.

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies—

Description of Business and Organization:

Organized in 1983, WorldCom, Inc., a Georgia corporation, provides a broad range of communications services to both U.S. and non-U.S. based businesses and consumers. We are a global communications company utilizing a strategy based on being able to provide service through our own facilities throughout the world instead of being restricted to a particular geographic location. We call this our “on-net” strategy. The on-net approach allows our customers to send data or voice communications across town, across the US., or to any of our networks in Europe or Asia, often without ever leaving our networks. The on-net approach provides our customers with superior reliability and low operating costs. Our core business is communications services, which includes voice, data, Internet and international services. We serve as a holding company for our subsidiaries’ operations. References herein to WorldCom, “we,” “our,” or “us” include WorldCom, Inc. and its subsidiaries, unless the context otherwise requires.

Basis of Combination and Presentation:

On June 7, 2001, our shareholders approved a recapitalization involving the creation of two separately traded tracking stocks:

- WorldCom group stock, which is intended to reflect the performance of our data, Internet, international and commercial voice businesses and is quoted on The Nasdaq National Market under the trading symbol “WCOM”, and
- MCI group stock, which is intended to reflect the performance of our consumer, small business, wholesale long distance voice and data, wireless messaging and dial-up Internet access businesses and is quoted on The Nasdaq National Market under the trading symbol “MCIT”.

In connection with the recapitalization, we amended our articles of incorporation to replace our existing common stock with two new series of common stock that are intended to reflect, or track, the performance of the businesses attributed to the WorldCom group and the MCI group. Effective with the recapitalization on June 7, 2001, each share of our existing common stock was changed into one share of WorldCom group stock and $\frac{1}{25}$ of a share of MCI group stock.

A tracking stock is a separate class of a company’s common stock intended to provide a return to investors based upon the financial performance of a distinct business unit of the company, sometimes referred to as the targeted business. These targeted businesses are collections of businesses that we have grouped together in order for us to issue WorldCom group stock and MCI group stock. The ownership of the targeted business does not change, and while each of the classes of stock trade separately, all shareholders are common shareholders of a single company, WorldCom, and are subject to all risks of an investment in WorldCom as a whole.

During the second quarter of 2001, we declared the initial quarterly dividend for the MCI group stock. A cash dividend of \$0.60 per share of MCI group stock, or approximately \$70 million in the aggregate, was paid on October 15, 2001 to shareholders of record as of the close of business on September 28, 2001. Dividends of \$0.60 per share of MCI group stock were also declared in the third and fourth quarters of 2001, which have been or will be paid in 2002.

The MCI group was initially allocated notional debt of \$6 billion and our remaining debt was allocated on a notional basis to the WorldCom group. We intend, for so long as the WorldCom group

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies — (Continued)

stock and the MCI group stock remains outstanding, to include in our filings under the Securities Exchange Act of 1934, as amended, the combined financial statements of each of the WorldCom group and the MCI group. These combined financial statements will be prepared in accordance with accounting principles generally accepted in the United States, and in the case of annual financial statements, will be audited. These combined financial statements are not legally required under current law or SEC regulations.

Voting rights of the holders of the WorldCom group stock and the MCI group stock are prorated based on the relative market values of WorldCom group stock and MCI group stock. We will conduct shareholder meetings that encompass all holders of voting stock. The WorldCom group and the MCI group shareholders will vote together as a single class on all matters brought to a vote of shareholders, including the election of our directors.

Our board of directors may at any time convert each outstanding share of MCI group stock into shares of WorldCom group stock at 110% of the relative trading value of MCI group stock for the 20 days prior to the announcement of the conversion. No premium will be paid on a conversion that occurs after June 7, 2004.

If all or substantially all of the WorldCom group or MCI group assets are sold, either: (i) the relevant shareholders will receive a distribution equal to the fair value of the net proceeds of the sale, either by special dividend or by redemption of shares; or (ii) each outstanding share of MCI group stock will be converted into shares of WorldCom group stock at 110% or 100% of the relative trading value of MCI group stock for a 10 trading day period following the sale.

Intergroup Allocation Policies:

Tracking Stock Policy Statement

Our board of directors has fiduciary duties to all shareholders of WorldCom, and no independent fiduciary duties to the holders of WorldCom group stock and MCI group stock. Our board of directors has adopted a policy statement regarding the WorldCom group and the MCI group matters. Our board of directors or any special committee appointed by our board of directors, may, without shareholder approval, change the policies set forth in our policy statement. Our board of directors or any special committee appointed by our board of directors also may, without shareholder approval, adopt additional policies or make exceptions with respect to the application of the policies described in our policy statement in connection with particular facts and circumstances, all as they may determine to be in the best interests of WorldCom. The material provisions of the policy statement are as follows:

General Policy. The policy statement provides that all material matters as to which the holders of WorldCom group stock and MCI group stock may have potentially divergent interests will be resolved in a manner that our board of directors or any special committee appointed by our board of directors determines to be in the best interests of WorldCom as a whole, after giving due consideration to the potentially divergent interests and all other interests of the holders of the separate series of common stock of WorldCom that our board of directors or any special committee, as the case may be, deems relevant. The policy statement provides that we will manage the businesses in the WorldCom group and the MCI group in a manner intended to maximize the operations, assets and values of both groups, and

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies — (Continued)

with complementary deployment of personnel, capital and facilities, consistent with their respective business objectives.

Under this policy statement, all material transactions which are determined by our board of directors to be in the ordinary course of business between the WorldCom group and the MCI group, except for those described in the paragraphs below, are intended to be on terms consistent with terms that would be applicable to arm's-length dealings with unrelated third parties.

Cash Management. Decisions regarding the investment of surplus cash, the issuance and retirement of debt, and the issuance and repurchase of common and preferred stock will continue to be made by WorldCom management on behalf of the groups. Under this centralized cash management system, the MCI group will generally not be allocated any cash balances.

Corporate Allocations

Corporate allocations have been attributed and/or allocated to the WorldCom group or the MCI group based upon identification of such services specifically benefiting each group. Such corporate allocations may change at our discretion and do not require shareholder approval. Management believes that the allocation methodologies applied are reasonable and these methods have been consistently applied for all periods presented. However, it is not practical to determine whether the allocated amounts represent amounts that would have been incurred on a stand alone basis. Explanations of the composition and the method of allocation for such items are described below.

Shared Corporate Services. We have directly charged specifically identifiable costs to the WorldCom group and the MCI group. Where determinations based on specific usage alone were impracticable, we used other allocation methods that we believe are fair, including methods based on factors such as the number of employees and total line costs or revenues generated by each group. For the years ended December 31, 1999, 2000 and 2001, the WorldCom group was allocated \$1.6 billion, \$2.0 billion and \$2.0 billion of these costs, respectively.

Commercial Inter-Group Transactions. The MCI group is allocated a proportion, based on usage, of our fiber optic system costs for use of the fiber optic systems, which are attributed to the WorldCom group and the WorldCom group is allocated a corresponding decrease to depreciation expense which totaled \$189 million, \$373 million and \$360 million for the years ended December 31, 1999, 2000 and 2001, respectively. In addition, the WorldCom group is allocated a proportion, based on usage, of our switching costs for use of the business voice switched services, which are attributed to the MCI group. For the years ended December 31, 1999, 2000 and 2001, switching costs allocated to the WorldCom group were \$64 million, \$87 million and \$101 million, respectively. Additionally, the MCI group is allocated a proportionate share of costs associated with buildings, furniture and fixtures attributed to the WorldCom group, and is also allocated costs for use of the MCI tradenames as discussed below. The WorldCom group is allocated a corresponding decrease to depreciation and amortization expense. For the years ended December 31, 1999, 2000 and 2001, these allocated costs totaled \$331 million, \$254 million and \$360 million, respectively.

All other material commercial transactions in the ordinary course of business between the groups are intended, to the extent practicable, to be on terms consistent with terms that would be applicable to

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies — (Continued)

arm's-length dealings with unrelated third parties and will be subject to the review and approval of our board of directors or any special committee. Neither group is under any obligation to use services provided by the other group, and each group may use services provided by a competitor of the other group if our board of directors or any special committee determines it is in the best interests of WorldCom as a whole.

Allocation of Intangible Assets. Intangible assets consist of the excess consideration paid over the fair value of net tangible assets acquired by us in business combinations accounted for under the purchase method and include goodwill, channel rights, developed technology and tradenames. These assets have been attributed to the respective groups based on specific identification and where acquired companies have been divided between the WorldCom group and the MCI group, the intangible assets have been attributed based on the respective fair values at the date of purchase of the related operations attributed to each group. Management believes that this method of allocation is equitable and provides a reasonable estimate of the intangible assets attributable to the WorldCom group and the MCI group.

All tradenames, including the MCI tradename and the other related MCI tradenames, have been attributed to the WorldCom group. The MCI group will be allocated an expense and the WorldCom group will be allocated a corresponding decrease in depreciation and amortization expense for the use of the MCI tradenames for the next four years based on the following fee schedule:

2002	\$30.0 million
2003:	\$35.0 million
2004:	\$40.0 million
2005:	\$45.0 million

Any renewal or termination of use of the MCI tradename by the MCI group will be subject to the general policy that our board of directors will act in the best interests of WorldCom. For each of the years ended December 31, 1999, 2000 and 2001, depreciation and amortization expense associated with the MCI tradenames allocated to the WorldCom group was decreased by \$27.5 million per annum for use of the MCI tradename:, by the MCI group.

Financing Arrangements. As of January 1, 1999, \$6.0 billion of our outstanding debt was notionally allocated to the MCI group and the remainder of our debt was notionally allocated to the WorldCom group. Our debt was allocated between the WorldCom group and the MCI group based upon a number of factors including estimated future cash flows and the ability to pay debt service and dividends of each of the groups. In addition, management considered certain measures of creditworthiness, such as coverage ratios and various tests of liquidity, in the allocation process. Our management believes that the initial allocation was equitable and supportable by both the WorldCom group and the MCI group. The debt allocated to the MCI group bears interest at a rate indicative of the rate at which the MCI group would borrow from third parties if it was a wholly owned subsidiary of WorldCom but did not have the benefit of any guarantee by WorldCom. Interest rates are calculated on a quarterly basis. Debt allocated to the MCI group bears an interest rate equal to the weighted-average interest rate, excluding capitalized interest, of WorldCom debt plus 1% percent. Interest allocated to the WorldCom group reflects the difference between our actual interest expense and the interest expense charged to the MCI

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies — (Continued)

group. Subsequent to the recapitalization, each group's allocated debt increases or decreases by the amount of any **net** cash generated by, or required to fund, the group's operating activities, investing activities, dividend payments, share repurchases **and** other financing activities.

As of December 31, 2001, our receivables purchase program consisted of a \$3.7 billion pool of receivables in which the purchaser owned an undivided interest, including the \$2.0 billion sold, of which \$2.8 billion and \$1.7 billion relate to the WorldCom group, respectively. The receivables sold were assigned based on specific identification where practical, or allocated based on total revenues. Our management believes that this method of allocation is equitable and provides a reasonable estimate of the receivables attributable to the groups.

Embratel Deconsolidation:

During the second quarter of 2001, we reached a long-term strategic decision to restructure our investment in Embratel Participações S.A., or Embratel. The restructuring included the resignation of certain Embratel board of directors seats, the irrevocable obligation to vote a portion of our common shares in a specified manner and the transfer of certain economic rights associated with such shares to an unrelated third party. Based on these actions, the accounting principles generally accepted in the United States prohibit the continued consolidation of Embratel's results. Accordingly, we have deconsolidated Embratel's results effective January 1, 2001.

As of December 31, 2001, our carrying value for our 19.3% ownership interest in Embratel was \$992 million which is included in the other assets in the accompanying combined financial statements. Our equity in Embratel's **loss** for 2001 is included in miscellaneous income/(expense) in the accompanying combined financial statements. Our investment in Embratel has been allocated to the WorldCom group.

Fair Value of Financial Instruments:

See Note 1 to our consolidated financial statements for additional fair value descriptions.

Cash and Cash Equivalents:

We consider cash in banks and short-term investments with original maturities of three months or less **as** cash and cash equivalents.

Property and Equipment:

Property and equipment are stated at cost. Depreciation is provided for financial reporting purposes using the straight-line method over the following estimated useful lives:

Transmission equipment (including conduit)	4 to 40 years
Communications equipment	5 to 10 years
Furniture, fixtures, buildings and other . . .	4 to 39 years

We evaluate the recoverability of property and equipment when events and circumstances indicate that such assets might be impaired. We determine impairment by comparing the undiscounted future

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED **FINANCIAL** STATEMENTS (Continued)
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies— (Continued)

cash flows estimated to be generated by these assets to their respective carrying amounts. In the event an impairment exists on property and equipment attributed to the WorldCom group, a loss will be recognized by the WorldCom group based on the amount by which the carrying value exceeds the fair value of the asset. If quoted market prices for an asset are not available, fair market value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risk involved. Losses on property and equipment to be disposed of are determined in a similar manner, except that fair market values are reduced for the cost to dispose.

Maintenance and repairs are expensed as incurred. Replacements and betterments are capitalized. The cost and related reserves of assets sold or retired are removed from the accounts, and any resulting gain or loss is reflected in results of operations.

We construct certain of our own transmission systems and related facilities. Internal costs directly related to the construction of such facilities, including interest and salaries of certain employees, are capitalized. Such internal costs were \$625 million (\$339 million in interest), \$842 million (\$495 million in interest) and \$858 million (\$498 million in interest) in 1999, 2000 and 2001, respectively, and have been allocated to the WorldCom group.

Goodwill and Other Intangible Assets:

The major classes of intangible assets attributed to the WorldCom group as of December 31, 2000 and 2001 are summarized below (in millions):

	<u>Amortization Period</u>	<u>2000</u>	<u>2001</u>
Goodwill	5 to 40 years	\$35,596	\$40,551
Tradenames	40 years	1,100	1,112
Developed technology	5 to 10 years	1,590	1,590
Other intangibles	5 to 10 years	2,665	3,414
		<u>40,951</u>	<u>46,667</u>
Less: accumulated amortization		<u>(4,266)</u>	<u>(5,849)</u>
Goodwill and other intangible assets, net		<u>\$36,685</u>	<u>\$40,818</u>

Intangible assets are amortized using the straight-line method for the periods noted above.

Goodwill is recognized for the excess of the purchase price of the various business combinations over the value of the identifiable net tangible and intangible assets acquired. Realization of acquisition-related intangibles, including goodwill, is periodically assessed by our management based on the current and expected future profitability and cash flows of acquired companies and their contribution to the overall operations of the WorldCom group.

Also included in other intangibles are costs incurred to develop software for internal use. Such costs were \$354 million, \$765 million and \$364 million for the years ended December 31, 1999, 2000 and 2001, respectively.

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies— (Continued)

Investments in Marketable **Equity** Securities:

Investments in marketable equity securities are classified as available-for-sale securities and reported at fair value. Unrealized holding gains and losses, net of taxes, are reflected as a component of allocated net worth in the accompanying combined financial statements. See Note 3 to our consolidated financial statements for additional investment disclosures.

Foreign Currency Translation:

Assets and liabilities recorded in foreign currencies are translated at the exchange rate as of the balance sheet date. Translation adjustments are recorded as a separate component of allocated net worth. All revenue and expense accounts are translated at a weighted-average of exchange rates in effect during the period. Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the results of operations as incurred. The accompanying combined statements of operations include foreign currency transaction losses, after elimination of minority interests, of \$36 million and \$38 million for the years ended December 31, 1999 and 2000, respectively, and foreign currency transaction gains of \$9 million for the year ended December 31, 2001.

Recognition of Revenues:

The WorldCom group records revenues for telecommunications services at the time of customer usage. Service activation and installation fees are amortized over the average customer contract life.

Accounting for International Long Distance Traffic and Other:

The WorldCom group enters into operating agreements with telecommunications carriers in foreign countries under which international long distance traffic is both delivered and received. The terms of most switched voice operating agreements, as well as established FCC policy, require that inbound switched voice traffic from the foreign carrier to the United States be routed to United States international carriers, like the WorldCom group, in proportion to the percentage of United States outbound traffic routed by that United States international carrier to the foreign carrier. Mutually exchanged traffic between the WorldCom group and foreign carriers is settled in cash through a formal settlement policy that generally extends over a six-month period at an agreed upon settlement rate. International settlements are treated as an offset to line costs. This reflects the way in which the business is operated because the WorldCom group actually settles in cash through a formal net settlement process that is inherent in the operating agreements with foreign carriers.

Reciprocal compensation represents a reimbursement of costs for call termination performed on behalf of other carriers' customers and is determined contractually based on fixed rate per minute charges to those carriers. As such, we have determined that it is more appropriate to reflect this reimbursement of our cost as an offset to cost of sales rather than reporting this reimbursement on a gross basis as revenues. During the years ended December 31, 1999, 2000 and 2001, reciprocal compensation recorded by the WorldCom group was \$395 million, \$400 million and \$248 million, respectively.

WorldCom Group (an integrated business of **WorldCom, Inc.**)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies—(Continued)

Derivative Financial Instruments:

Effective January 1, 2001, we adopted **SFAS No. 133**. This statement establishes accounting and reporting standards requiring that derivative instruments (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at fair value. **As** of January 1, 2001, our exposure to derivative financial instruments primarily consisted of option collar transactions designated as cash flow hedges of anticipated sales of an equity investment, which we maintain to minimize the impact of adverse changes in the market price of the related equity investment. The initial adoption of **SFAS No. 133** provided a **net** transition gain from our designated cash flow hedges resulting in an increase in other comprehensive income of approximately \$28 million. During 2001, shares of the hedged equity investment were sold and we reclassified respective hedging gains of \$110 million from accumulated comprehensive income to miscellaneous income. **As** of December 31, 2001, we maintain no derivative financial instruments. No amounts were reclassified to earnings resulting from any ineffective portion of the designated derivative hedges or from the discontinuance of designation of any cash flow hedges. All of our derivative instrument activity was attributed to the WorldCom group.

Cumulative Effect of Accounting Change:

During the fourth quarter of 2000, the WorldCom group implemented **SAB 101**, which requires certain activation and installation fee revenues to be amortized over the average life of the related service rather than be recognized immediately. Costs directly related to these revenues may also be deferred and amortized over the customer contract life. **As** required by **SAB 101**, the WorldCom group retroactively adopted this accounting effective January 1, 2000, which resulted in a one-time expense of \$75 million, net of income tax benefit of \$43 million. The pro forma effect of adopting **SAB 101** on periods prior to January 1, 2000 was not material to the WorldCom group's financial position or results of operations.

Income Taxes:

The federal and state income tax liabilities incurred by WorldCom and which are determined on a consolidated, combined, or unitary basis are allocated between the WorldCom group and the MCI group in accordance with our policy statement. The income tax expense or benefit for each group and the balance sheet allocation of the expense is based on a comparison of our tax expense with the hypothetical tax expense or benefit of the MCI group. The tax expense or benefit allocable to the MCI group is the amount that the MCI group would have incurred if it had filed tax returns as a separate taxpayer and the tax expense allocable to the WorldCom group is the excess, if any, of our tax expense over the tax expense or benefit allocable to the MCI group. Tax benefits that cannot be used by a group generating those benefits but can be used on a consolidated basis are credited to the group that generated those benefits. Had the WorldCom group and the MCI group filed separate tax returns, the provision for income taxes and net income for each group would not have significantly differed from the amounts reported on the group's combined statements of operations for the years ended December 31, 1999, 2000 and 2001. However, the amounts of current and deferred taxes and taxes payable or refundable attributed to each group on the historical financial statements may differ from those that

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies—(Continued)

would have been allocated had the WorldCom group or the MCI group filed separate income tax returns.

Deferred tax assets and liabilities are based on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and their respective tax bases, and the impact of available net operating loss, or NOL, carryforwards. Valuation allowances have been recorded to reduce the deferred tax asset to the amount more likely than not to be realized.

Earnings Per Share:

Our consolidated financial statements present basic and diluted earnings (loss) per share for WorldCom group stock and MCI group stock using the two-class method. The two-class method is an earnings formula that determines the attributed earnings (loss) per share for WorldCom group stock and MCI group stock according to participation rights in undistributed earnings. The combined financial statements of the WorldCom group do not present earnings per share because WorldCom group stock is a series of our common stock, and the WorldCom group is not a legal entity with a capital structure.

For purposes of our consolidated financial statements, basic earnings per share attributed to WorldCom group stock is computed by dividing attributed net income for the period by the number of weighted-average shares of WorldCom group stock then outstanding. Diluted earnings per share attributed to WorldCom group stock is computed by dividing attributed net income for the period by the weighted-average number of shares of WorldCom group stock outstanding, including the dilutive effect of WorldCom group stock equivalents.

Concentration of Credit Risk

A portion of the WorldCom group's revenues is derived from services provided to other telecommunications service providers. As a result, the WorldCom group has some concentration of credit risk among its customer base. The WorldCom group performs ongoing credit evaluations of its larger customers' financial condition and, at times, requires collateral from its customers to support its receivables, usually in the form of assignment of its customers' receivables to the WorldCom group in the event of nonpayment.

Recently Issued Accounting Standards:

In June 2001, the FASB issued SFAS No. 141 "Business Combinations" and SFAS No. 142 "Goodwill and Other Intangible Assets." SFAS No. 141 requires business combinations initiated after June 30, 2001, which includes the Intermedia merger, to be accounted for using the purchase method of accounting and broadens the criteria for recording intangible assets separate from goodwill. Recorded goodwill and intangibles will be evaluated against this new criteria and may result in certain intangibles being subsumed into goodwill, or alternatively, amounts initially recorded as goodwill may be separately identified and recognized apart from goodwill. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests. The statement includes provisions for the identification of reporting units for purposes of assessing potential future impairments of goodwill. Upon adoption, we stopped amortizing

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies—(Continued)

intangible assets with indefinite useful lives, including goodwill and tradenames. Based on current levels of such assets, this will reduce amortization expense by approximately \$1.0 billion annually at the WorldCom group. Additionally, we are conducting impairment reviews of all intangible assets with indefinite useful lives and we expect to complete this assessment no later than the second quarter of 2002, in accordance with the provisions of SFAS No. 142. Based on our preliminary analyses, we estimate that as a result of the adoption of SFAS No. 142 we will reduce goodwill by approximately \$14 to \$19 billion for the WorldCom group.

In June 2001, the FASB issued SFAS No. 143 "Asset Retirement Obligations," which establishes new accounting and reporting standards for legal obligations associated with retiring assets. The fair value of a liability for an asset retirement obligation must be recorded in the period in which it is incurred, with the cost capitalized as part of the related long-lived assets and depreciated over the asset's useful life. Changes in the liability resulting from the passage of time will be recognized as operating expenses. SFAS No. 143 must be adopted by 2003. We have not yet quantified the impact of adopting SFAS No. 143 on our consolidated results of operations or financial position.

In August 2001, the FASB issued SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets," which supersedes both SFAS No. 121 "Accounting for the Impairment of Long-Lived Assets for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions for the disposal of a segment of a business contained in APB Opinion No. 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." SFAS No. 144 establishes a single accounting model for long-lived assets to be disposed of by sale and broadens the presentation of discontinued operations. The provisions of SFAS No. 144 are effective beginning in 2002 and are not expected to have a material impact on our consolidated results of operations or financial position.

Use of Estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States, or GAAP, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the period reported. Actual results could differ from those estimates. Estimates are used when accounting for allowance for doubtful accounts, revenue reserves, depreciation and amortization, taxes and contingencies.

(2) Business Combinations—

We have acquired other telecommunications companies offering similar or complementary services to those offered by us. These acquisitions have been accomplished through the purchase of the outstanding stock or assets of the acquired entity for cash, notes, shares of our common stock, or a combination thereof. The cash portion of acquisition costs has generally been financed through our bank credit facilities.

On July 1, 2001, we acquired Intermedia Communications Inc. for approximately \$5.8 billion, including assumed long-term debt, pursuant to the merger of a wholly owned subsidiary with and into Intermedia, with Intermedia continuing as the surviving corporation and as a subsidiary of WorldCom.

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(2) Business Combinations—(Continued)

As a result of the Intermedia merger, we acquired a controlling interest in Digex, Incorporated, or Digex, a provider of managed Web and application hosting services. In connection with the Intermedia merger, stockholders of Intermedia received one share of WorldCom group stock (or 57.1 million WorldCom group shares in the aggregate) and 1/25th of a share of MCI group stock (or 2.3 million MCI group shares in the aggregate) **for** each share of Intermedia common stock they owned. Holders of Intermedia preferred stock, other than Intermedia's 13.5% Series B Redeemable Exchangeable Preferred Stock due 2009, or Intermedia Series B Preferred Stock, received one share of a class or series of our preferred stock, with substantially identical terms, which were established upon consummation of the Intermedia merger. **As** a result of the merger with Intermedia, we own approximately 90% of the voting securities of Intermedia.

Upon effectiveness of the merger with Intermedia, the then outstanding and unexercised options for shares of Intermedia common stock were converted into options exercisable for an aggregate of approximately 10 million shares of WorldCom group stock having the same terms and conditions **as** the Intermedia options, except that the exercise price and the number of shares issuable upon exercise were divided and multiplied, respectively, by 1.0319. The merger with Intermedia was accounted for **as** a purchase and was allocated to the WorldCom group.

The purchase price in the Intermedia merger **was** allocated based on appraised fair values at the date of acquisition. This resulted in an excess purchase price over net assets acquired of \$5.1 billion of which \$67 million was allocated to customer lists, which will be amortized over approximately four years on a straight-line basis. The remaining excess of \$5.0 billion has been allocated to goodwill and tradename which are not subject to amortization and the goodwill is not expected to be deductible for tax purposes.

In connection with the Intermedia merger, the Antitrust Division of the Department of Justice required us to dispose of Intermedia's Internet service provider business, which provided integrated Internet connectivity solutions, and effective December 1, 2001, we sold substantially **all** of the Internet related assets for approximately \$12 million. In addition to this required divestiture, we also committed to a plan to sell Intermedia's Advanced Building Network business, which provides centralized telecommunications services in multi-tenant commercial office buildings, and the systems integration business through which Intermedia sells, installs, operates and maintains business telephony customer premise equipment for its customers. We included the appraised fair values of these assets to be disposed of in our initial allocation of the Intermedia purchase price and also included accrued anticipated **losses** expected to be incurred through disposal date. Any difference between the actual results of operations and the amounts accrued will result in an adjustment of goodwill unless there is a difference resulting from a post-merger event. **For** the year ended December 31, 2001, operating **losses** for these assets to be disposed **of** were approximately \$41 million, before corporate allocations. We anticipate that we will complete the planned disposals of the remaining identified businesses before the third quarter of 2002.

During 1999, 2000 and 2001, we recorded other liabilities of \$582 million, \$29 million and \$254 million, respectively, related to estimated costs of unfavorable commitments of acquired entities, and other non-recurring costs arising from various acquisitions and mergers. At December 31, 1999, 2000 and 2001, other liabilities attributed to the WorldCom group related to these and previously recorded accruals totaled \$1.6 billion, \$832 million and \$764 million, respectively.

Worldcorn Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(3) Long-Term Debt—

Our outstanding debt as of December 31, 2000 and 2001 consists of the following (in millions):

	<u>2000</u>	<u>2001</u>
Commercial paper and credit facilities	\$ 3,629	\$ —
Floating rate-notes due 2001 through 2002	1,560	60
7.88% - 8.25% Notes Due 2003-2010	3,500	3,500
7.38% Notes Due 2006-2011	2,000	2,000
6.13% - 6.95% Notes Due 2001-2028	6,100	4,600
7.13% - 7.75% Notes Due 2004-2027	2,000	2,000
8.88% Senior Notes Due 2006	672	—
7.13% - 8.25% Senior Debentures Due 2023-2027	1,436	1,434
6.13% - 7.50% Senior Notes Due 2004-2012	1,934	1,925
6.50% - 8.25% Notes Due 2004-2031	—	11,939
Intermedia 11.25%-12.25% Senior Discount Notes Due 2007-2009	—	643
Intermedia 8.50%-9.50% Senior Notes Due 2007-2009	—	581
Capital lease obligations (maturing through 2017)	413	953
Embratel debt	1,134	—
Other debt (maturing through 2008)	518	575
	<u>24,896</u>	<u>30,210</u>
Notional debt allocated to the MCI group	(6,000)	(5,505)
Notional debt allocated to the WorldCom group	18,896	24,705
Short-term debt and current maturities of allocated WorldCom group long-term debt	(7,200)	(172)
	<u>\$11,696</u>	<u>\$24,533</u>

See Note 1 for a more detailed description of how we allocate debt to the groups and Note 4 of our consolidated financial statements for additional debt descriptions.

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(4) Company Obligated Mandatorily Redeemable Preferred Securities of Subsidiaries and Other Redeemable Preferred Securities—

In connection with the Intermedia merger, we issued the following series of preferred stock, which are mandatorily redeemable:

	Number of Preferred Shares Authorized, Issued and Outstanding	Liquidation Preference Per Preferred Share	Annual Dividend Per Preferred Share	Associated Depository Shares	Aggregate # of Shares Convertible at the Option of Holder	
					WorldCom Group Shares	MCI Group Shares
Series D Junior Convertible preferred stock, par value \$0.01 per share	53,724	\$2,500	\$175	5,372,410	6,905,398	276,215
Series E Junior Convertible preferred stock, par value \$0.01 per share	64,047	\$2,500	\$175	6,404,690	5,295,766	211,830
Series F Junior Convertible preferred stock, par value \$0.01 per share	79,600	\$2,500	\$175	7,960,000	4,729,649	189,185
Series G Junior Convertible Participating preferred stock, par value \$0.01 per share . .	200,000	\$1,000	\$ 70	n/a	5,555,555	222,222

On August 20, 2001, the holder of our Series G preferred stock exercised its right to require us to redeem all of the outstanding Series G preferred stock at par plus accrued dividends, or approximately \$200 million in the aggregate.

The Series D, E and F preferred stock are currently redeemable in whole or in part, at our option for cash plus accrued and unpaid dividends at rates commencing with 103%, declining to 100% in 2004 and thereafter for the Series D and E preferred stock and commencing with 104%, declining to 100% in 2005 and thereafter for the Series F preferred stock.

Dividends on the Series D, E and F preferred stock are payable in cash or shares of our common stock, at our election on each July 15, October 15, January 15 and April 15. To date, we have paid these dividends in cash and we expect to continue to pay cash dividends on our Series D, E and F preferred stock.

The Series D, E and F preferred shareholders are generally entitled to one-tenth of a vote per share of Series D, E or F preferred stock on all matters voting together with WorldCom common shareholders as a single class.

Redeemable Preferred Securities of Subsidiaries:

At the time of the Intermedia merger, Intermedia had outstanding Intermedia Series B Preferred Stock, and Digex had outstanding Series A Convertible Preferred Stock, or Digex Series A Preferred Stock, that remain outstanding subsequent to the Intermedia merger.

As of December 31, 2001, there were 568,455 shares of Intermedia Series B Preferred Stock outstanding. Dividends on the Intermedia Series B Preferred Stock accumulate at a rate of 13.5% of the aggregate liquidation preference thereof and are payable quarterly, in arrears. Dividends are payable in cash or, at Intermedia's option, by the issuance of additional shares of Intermedia Series B Preferred Stock having an aggregate liquidation preference equal to the amount of such dividends. Historically, Intermedia has paid the Intermedia Series B Preferred Stock dividend by the issuance of additional shares of Intermedia Series B Preferred Stock. The Intermedia Series B Preferred Stock is

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(4) Company Obligated Mandatorily Redeemable Preferred Securities of Subsidiaries and Other Redeemable Preferred Securities—(Continued)

subject to mandatory redemption at its liquidation preference of \$1,000 per share, plus accumulated and unpaid dividends on March 31, 2009. The Intermedid Series B Preferred Stock will be redeemable at the option of Intermedia at any time after March 31, 2002 at rates commencing with 106.75%, declining to 100% on March 31, 2007. Intermedia Series B Preferred Stock is generally entitled to one-tenth of one vote per share on all matters voting together with the common stock of Intermedia as a single class.

The Digex Series A Preferred Stock has an aggregate liquidation preference of \$100 million, and is convertible into approximately 1,462,000 shares of Class A Common Stock of Digex. The Digex Series A Preferred Stock does not pay dividends and there are no voting rights.

As of December 31, 2001, we also had \$750 million aggregate principal amount of 8% Cumulative Quarterly Income Preferred Securities, Series A, representing 30 million shares outstanding due June 30, 2026 and 475 shares of an authorized 500 shares of 6.375% cumulative preferred stock, Class A, or Class A Preferred Stock. Each share of Class A Preferred Stock has a par value of \$0.01 per share and a liquidation preference of \$100,000 per share. The Class A Preferred Stock is mandatorily redeemable at the redemption price of \$100,000 per share plus accumulated and unpaid dividends on January 1, 2019. Dividends on the Class A Preferred Stock are payable quarterly at a rate per annum equal to 6.375% of the liquidation preference of \$100,000 per share when, as and if declared.

(5) Preferred Stock—

In October 2001, we exercised our option to redeem all of our outstanding Series B Preferred Stock. Prior to the redemption date, substantially all of the holders of our Series B Preferred Stock elected to convert the preferred stock into 0.1460868 shares of WorldCom group stock and 0.005843472 shares of MCI group stock for each share of Series B Preferred Stock held.

In January 2000, each outstanding share of Series C \$2.25 Cumulative Convertible Exchangeable Preferred Stock was redeemed by us for \$50.75 in cash, or approximately \$190 million in the aggregate.

(6) Shareholder Rights Plan—

See Note 7 to our consolidated financial statements for a detailed description of our existing shareholder rights plan.

(7) Leases and Other Commitments—

WorldCom leases office facilities and equipment under non-cancelable operating and capital leases and is also obligated under various right-of-way agreements having initial or remaining terms of more than one year and allocates rent expense on these leases attributable to the WorldCom group and the MCI group in accordance with our allocation policies. Rental expense allocated to the WorldCom group under these operating leases was \$160 million, \$203 million and \$304 million in 1999, 2000 and 2001, respectively. The WorldCom group's rental expense in 2001 increased as a result of our movement of technical facilities closer to our customers which should result in lower access costs in the

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(7) Leases and Other Commitments—(Continued)

future, international expansion and to a lesser degree, the inclusion of Intermedia and annual rent escalation.

The WorldCom group is an integrated business of WorldCom and is therefore subject to all our liabilities and obligations, including leases and other commitments. See Note 8 to WorldCom's consolidated financial statements for a description of our leases and other commitments.

(8) Contingencies —

The WorldCom group shareholders are subject to all of the risks related to an investment in WorldCom and the WorldCom group, including the effects of any legal proceedings and claims against the MCI group. See Note 9 to our consolidated financial statements for information related to our contingencies.

(9) Employee Benefit Plans —

Stock Option Plans:

WorldCom has several stock option plans under which options to acquire shares of WorldCom group stock may be granted to directors, officers and employees of the WorldCom group and the MCI group. WorldCom accounts for these plans under APB Opinion No. 25, under which no compensation cost is recognized. Terms and conditions of WorldCom's options, including exercise price and the period in which options are exercisable, generally are at the discretion of the Compensation and Stock Option Committee of our board of directors; however, no options are exercisable for more than 10 years after date of grant.

401(k) Plans:

WorldCom offers our qualified employees the opportunity to participate in one of our defined contribution retirement plans qualifying under the provisions of Section 401(k) of the Internal Revenue Code. Each employee may contribute on a tax deferred basis a portion of annual earnings not to exceed \$10,500. WorldCom matches individual employee contributions in selected plans, up to a maximum level which in no case exceeds 6% of the employee's compensation. Expenses allocated to the WorldCom group relating to our 401(k) plans were \$45 million, \$44 million and \$47 million for the years ended December 31, 1999, 2000 and 2001, respectively.

Pension and Other Post-retirement Benefit Plans:

We maintain various defined benefit plans and other post-retirement benefit plans that cover selected eligible employees of the WorldCom group and the MCI group. Annual service cost is determined using the Projected Unit Credit actuarial method, and prior service cost is amortized on a straight-line basis over the average remaining service period of employees.

See Notes 10 and 11 to our consolidated financial statements for additional disclosures related to employee benefit plans.

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(10) Income Taxes—

The WorldCom group combined balance sheets reflect the anticipated tax impact of future taxable income or deductions implicit in the combined balance sheets in the form of temporary differences. These temporary differences reflect the difference between the basis in the assets and liabilities for financial reporting purposes and amounts used **for** income tax purposes and the impact of available NOL carryforwards as measured in the WorldCom group's combined financial statements and **as** measured by tax laws using enacted tax rates.

The provision **for** income taxes **is** composed of the following (in millions):

	<u>1999</u>	<u>2000</u>	<u>2001</u>
Current..	\$ (654)	\$ 580	\$ (188)
Deferred	2,510	1,410	1,131
Total provision for income taxes	<u>\$1,856</u>	<u>\$1,990</u>	<u>\$ 943</u>

The following is a reconciliation of the provision **for** income taxes to the expected amounts using the statutory rate:

	<u>1999</u>	<u>2000</u>	<u>2001</u>
Expected statutory amount	35.0%	35.0%	35.0%
Nondeductible amortization of excess of cost over net tangible assets acquired	6.7	6.0	10.4
State income taxes	2.5	2.6	(5.0)
Valuation allowance	(2.5)	—	—
Tax credits	(0.2)	(0.4)	(1.9)
Other	<u>0.6</u>	<u>(3.1)</u>	<u>0.3</u>
Actual tax provision	<u>42.1%</u>	<u>40.1%</u>	<u>38.8%</u>

The following is a summary of the significant components of the WorldCom group's attributed deferred tax assets and liabilities **as** of December 31, 2000 and 2001 (in millions):

	<u>2000</u>		<u>2001</u>	
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
Fixed assets	\$ —	\$(3,957)	\$ —	\$(4,488)
Goodwill and other intangibles	—	(167)	—	(52)
Investments	363	—	392	—
Other assets.	—	(264)	—	(423)
Accrued liabilities.	745	—	348	—
NOL carryforwards.	517	—	1,186	—
Tax credits	692	—	676	—
Other	—	(290)	—	(129)
	<u>2,317</u>	<u>(4,678)</u>	<u>2,602</u>	<u>(5,092)</u>
Valuation allowance	<u>(191)</u>	<u>—</u>	<u>(465)</u>	<u>—</u>
	<u>\$2,126</u>	<u>\$(4,678)</u>	<u>\$2,137</u>	<u>\$(5,092)</u>

WorldCom **Group** (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(10) Income Taxes— (Continued)

At December 31, 2001, the WorldCom group was attributed unused NOL carryforwards for federal income tax purposes of approximately \$3.1 billion which expire in various amounts during the years 2011 through 2021. These NOL carryforwards result in a deferred tax asset of approximately \$1.2 billion at December 31, 2001.

Approximately \$1.7 billion of NOL carryforwards for federal income tax purposes relate to preacquisition NOL carryforwards attributable to entities acquired in transactions accounted for as purchases. These carryforwards and other deferred tax assets result in deferred tax assets for which a valuation allowance of \$433 million has been established. If subsequent events or conditions dictate an increase in the need for a valuation allowance attributable to such deferred tax assets, the income tax expense for that period will be increased accordingly.

In addition, at December 31, 2001 the WorldCom group was attributed unused NOL carryforwards of \$85 million outside the United States which generally do not expire. These carryforwards result in a \$32 million deferred tax asset for which a valuation allowance has been established.

(11) Supplemental Disclosure of Cash Flow Information—

Interest paid by the WorldCom group during the years ended December 31, 1999, 2000 and 2001 amounted to \$816 million, \$488 million and \$886 million, respectively. Income taxes paid by the WorldCom group, net of refunds, during the years ended December 31, 1999, 2000 and 2001 were \$35 million, \$28 million and \$148 million, respectively.

In conjunction with business combinations attributed to the WorldCom group, assets acquired and liabilities assumed, including revisions to previously recorded acquisitions, and WorldCom common stock issued were as follows (in millions):

	<u>1999</u>	<u>2000</u>	<u>2001</u>
Fair value of assets acquired	\$ (92)	\$ —	\$ 1,932
Goodwill and other intangible assets	2,041	43	5,102
Liabilities assumed	(935)	(29)	(4,201)
Preferred stock issued or assumed	—	—	(1,361)
WorldCom common stock issued	(228)	—	(1,266)
Net cash paid	<u>\$ 786</u>	<u>\$ 14</u>	<u>\$ 206</u>

(12) Segment and Geographic **Information**—

Based on our organizational structure, the WorldCom group operates in two reportable segments: Commercial voice, data and Internet and International operations. The WorldCom group's reportable segments represent business units that primarily offer similar products and services; however, the business units are managed separately due to the type and class of customer as well as the geographic dispersion of their operations. The Commercial voice, data and Internet segment includes voice, data and other types of domestic communications services for commercial customers, and Internet services including dedicated access and web and application hosting services. International operations provide

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(12) Segment and Geographic Information— (Continued)

voice, data, Internet and other similar types of communications services to customers primarily in Europe and the Asia Pacific region.

Our chief operating decision-maker utilizes revenue information in assessing performance and making overall operating decisions and resource allocations. Communications services are generally provided utilizing WorldCom's fiber optic networks, which do not make a distinction between the types of services provided. Profit and loss information is reported only on a combined basis to the chief operating decision-maker and our board of directors.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. Information about the WorldCom group's segments is as follows (in millions):

	<i>Revenues From External Customers</i>			<i>Selling, General and Administrative</i>			<i>Capital Expenditures</i>		
	1999	2000	2001	1999	2000	2001	1999	2000	2001
Voice, data and Internet	\$14,817	\$16,880	\$18,371	\$2,655	\$3,209	\$3,895	\$5,532	\$ 8,376	\$6,505
International operations	1,624	2,367	2,977	774	1,094	1,409	1,494	1,754	1,114
Corporate—other charges	—	—	—	—	433	754	—	—	—
Other	523	—	—	170	—	—	10	—	—
Total before Embratel	16,964	19,247	21,348	3,599	4,736	6,058	7,036	10,130	7,619
Embratel	2,854	3,662	—	610	980	—	893	854	—
Elimination of intersegment revenue/ expenses	(82)	(154)	—	(14)	(27)	—	—	—	—
Total	\$19,736	\$22,755	\$21,348	\$4,195	\$5,689	\$6,058	\$7,929	\$10,984	\$7,619

As discussed in Note 1, we deconsolidated our investment in Embratel as of January 1, 2001. Embratel, which provides communications services in Brazil, was designated as a separate reportable segment of the WorldCom group for periods prior to January 1, 2001. Accordingly, we have included Embratel in our WorldCom group segment information presented for 1999 and 2000.

Additionally, Other includes the operations of MCI Systemhouse Corp and SHL Systemhouse Co. which was sold to Electronic Data Systems Corporation in April 1999.

The following is a reconciliation of the segment information to income before income taxes, minority interests and cumulative effect of accounting change (in millions):

	1999	2000	2001
Revenues	\$19,736	\$22,755	\$21,348
Operating expenses	15,105	17,714	18,299
Operating income	4,631	5,041	3,049
Other income (expense):			
Interest expense	(460)	(458)	(1,029)
Miscellaneous	237	385	412
Income before income taxes, minority interests and cumulative effect of accounting change	<u>\$ 4,408</u>	<u>\$ 4,968</u>	<u>\$ 2,432</u>

WorldCom Group (an integrated business of WorldCom, Inc.)
NOTES TO COMBINED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(12) Segment and Geographic Information— (Continued)

Information about the WorldCom group's operations by geographic areas are as follows (in millions):

	1999		2000		2001	
	Revenues	Long-Lived Assets	Revenues	Long-Lived Assets	Revenues	Long-Lived Assets
United States	\$14,760	\$19,635	\$16,111	\$27,643	\$17,778	\$32,832
Brazil..	2,772	4,017	3,508	4,008	—	—
All other international.	<u>2,204</u>	<u>2,575</u>	<u>3,136</u>	<u>3,526</u>	<u>3,570</u>	<u>3,960</u>
Total	<u>\$19,736</u>	<u>\$26,227</u>	<u>\$22,755</u>	<u>\$35,177</u>	<u>\$21,348</u>	<u>\$36,792</u>

(13) Related Party Transactions—

See Note 16 to our consolidated financial statements for information pertaining to our related party transactions.

(14) Unaudited Quarterly Financial Data—

	Quarter Ended							
	March 31,		June 30,		September 30,		December 31,	
	2000	2001	2000	2001	2000	2001	2000	2001
	(in millions)							
Revenues	\$5,429	\$5,203	\$5,621	\$5,362	\$5,844	\$5,482	\$5,861	\$5,301
Operating income	1,390	966	1,364	310	1,139	999	1,148	774
Income before cumulative effect of accounting change	741	548	732	126	599	503	601	347
Net income..	649	532	716	110	583	460	585	305

INDEX TO FINANCIAL STATEMENTS

	<u>Page</u>
MCI Group (an integrated business of WorldCom, Inc.)	
Report of independent public accountants	F-75
Combined balance sheets as of December 31, 2000 and 2001	F-76
Combined statements of operations for the three years ended December 31, 2001	F-77
Combined statements of allocated net worth for the three years ended December 31, 2001 ...	F-78
Combined statements of cash flows for the three years ended December 31, 2001.	F-79
Notes to combined financial statements	F-80

You should understand the following when reading the combined financial statements of the MCI group, which is an integrated business of WorldCom, Inc.:

- WorldCom has presented the combined financial statements of the MCI group at substantially the same level of detail as the consolidated financial statements of WorldCom. WorldCom believes that investors require detailed financial information for the MCI group to properly evaluate the market potential of MCI group stock;
- the MCI group is a collection of WorldCom's MCI businesses and is not a separate legal entity;
- the holders of the MCI group stock are shareholders of WorldCom and do not have an ownership interest in the MCI group or any company in the MCI group or a claim on any of the assets attributed to the MCI group;
- the attribution of a portion of WorldCom's assets and liabilities to the MCI group does not affect WorldCom's ownership of these assets or responsibility for these liabilities and does not affect the rights of any creditor of WorldCom; and
- the assets attributed to the MCI group could be subject to the liabilities attributed to the WorldCom group.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Shareholders of WorldCom, Inc.:

We have audited the accompanying combined balance sheets of the MCI group (**an** integrated business of WorldCom, Inc.) (as described in Note 1) as of December 31, 2000 and 2001, and the related combined statements of operations, allocated net worth and cash flows for each of the years in the three-year period ended December 31, 2001. These financial statements are the responsibility **of** WorldCom, Inc.'s management. Our responsibility is to express **an** opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. **An** audit **also** includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the MCI group combined financial statements referred to above present fairly, in **all** material respects, the combined financial position **of** the MCI group **as** of December **31**, 2000 and 2001, and the combined results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1 to the combined financial statements, effective January 1, 2000, the MCI group changed its method of accounting for certain activation and installation fee revenues and expenses.

The MCI group is a fully integrated business of WorldCom, Inc. Accordingly, **as** described in Note 1, the MCI group's combined financial statements have been derived from the consolidated financial statements and accounting records **of** WorldCom, Inc. and, therefore, reflect certain assumptions and allocations. **As** more fully discussed in Note 1, the combined financial statements of the MCI group should be read in conjunction with the audited consolidated statements of WorldCom, Inc.

ARTHUR ANDERSEN LLP

Jackson, Mississippi
March 7, 2002

MCI GROUP (an integrated business of WorldCom, Inc.)
COMBINED BALANCE SHEETS
(In Millions)

	December 31, 2000	December 31, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 41	\$ 7
Accounts receivable, net of allowance for bad debts of \$514 in 2000 and \$393 in 2001	1,835	1,574
Deferred tax asset	41	10
Other current assets	395	335
Total current assets	<u>2,312</u>	<u>1,926</u>
Property and equipment:		
Transmission equipment	405	445
Communications equipment	2,227	2,444
Furniture, fixtures and other,	676	680
Construction in progress	170	130
	3,478	3,699
Accumulated depreciation	(1,232)	(1,682)
	<u>2,246</u>	<u>2,017</u>
Goodwill and other intangible assets	9,909	9,719
Other assets	168	227
	<u>\$14,635</u>	<u>\$13,889</u>
LIABILITIES AND SHAREHOLDERS' INVESTMENT		
Current liabilities:		
Payable to WorldCom group, net	\$ 649	\$ 900
Accrued interest	108	111
Accounts payable and accrued line costs	2,438	2,093
Other current liabilities	914	1,091
Total current liabilities	<u>4,109</u>	<u>4,195</u>
Long-term liabilities, less current portion:		
Long-term debt	6,000	5,505
Long-term payable to WorldCom group, net	976	976
Deferred tax liability	928	870
Other liabilities	159	30
Total long-term liabilities	<u>8,063</u>	<u>7,381</u>
Commitments and contingencies		
Allocated net worth	<u>2,463</u>	<u>2,313</u>
	<u>\$14,635</u>	<u>\$13,889</u>

The accompanying notes are an integral part of these combined statements.

MCI GROUP (an integrated **business** of WorldCom, **Inc.**)

COMBINED STATEMENTS OF OPERATIONS

(In Millions)

	For the Years Ended December 31,		
	1999	2000	2001
Revenues	<u>\$16,172</u>	<u>\$16,335</u>	<u>\$13,831</u>
Operating expenses:			
Line costs	7,087	7,177	7,080
Selling, general and administrative	5,071	5,162	5,348
Depreciation and amortization	<u>757</u>	<u>884</u>	<u>938</u>
Total.	<u>12,915</u>	<u>13,223</u>	<u>13,366</u>
Operating income	3,251	3,112	465
Other income (expense):			
Interest expense	(506)	(512)	(504)
Miscellaneous	<u>5</u>	<u>—</u>	<u>—</u>
Income (loss) before income taxes and cumulative effect of accounting change	2,156	2,600	(39)
Income tax expense (benefit).	<u>1,109</u>	<u>1,035</u>	<u>(16)</u>
Income (loss) before cumulative effect of accounting change	1,647	1,565	(23)
Cumulative effect of accounting change (net of income tax of \$7 in 2000)	—	<u>(10)</u>	<u>—</u>
Net income (loss)	<u>\$ 1,647</u>	<u>\$ 1,555</u>	<u>\$ (23)</u>

The accompanying notes are an integral part of these combined statements.

MCI GROUP (an integrated business of WorldCom, Inc.)
COMBINED STATEMENTS OF ALLOCATED NET WORTH
For the Three Years Ended December 31, 2001
(In Millions)

Allocated net worth at December 31, 1998	\$2,950
Net income	1,641
Advances to WorldCom group, net	<u>(2,097)</u>
Allocated net worth at December 31, 1999	2,500
Net income	1,555
Advances to WorldCom group, net	<u>(1,592)</u>
Allocated net worth at December 31, 2000	2,463
Net loss	(23)
Advances from WorldCom group, net	15
Dividends declared on MCI group common stock	<u>(142)</u>
Allocated net worth at December 31, 2001	<u>\$ 2,13</u>

The accompanying notes are an integral part of these combined statements.

MCI GROUP (an integrated business of WorldCom, Inc.)

COMBINED STATEMENTS OF CASH FLOWS

(In Millions)

	For the Years Ended December 31,		
	1999	2000	2001
Cash flows from operating activities:			
Net income (loss)	\$ 1,647	\$ 1,555	\$ (23)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Cumulative effect of accounting change	—	10	—
Depreciation and amortization	757	884	938
Provision for deferred income taxes (benefit)	393	239	(27)
Change in assets and liabilities, net of effect of business combinations:			
Accounts receivable, net	(264)	174	177
Other current assets	24	(215)	60
Accounts payable and other current liabilities	530	(960)	(133)
Payable to WorldCom group, net	555	649	251
All other operating activities	11	—	146
Net cash provided by operating activities	<u>3,653</u>	<u>2,336</u>	<u>1,389</u>
Cash flows from investing activities:			
Capital expenditures	(787)	(500)	(267)
Acquisitions and related costs	(292)	—	—
Increase in intangible assets	(354)	(167)	(327)
Decrease in other liabilities	(85)	(16)	(129)
All other investing activities	8	(90)	(149)
Net cash used in investing activities	<u>(1,510)</u>	<u>(773)</u>	<u>(872)</u>
Cash flows from financing activities:			
Principal repayments on debt, net	—	—	(495)
Dividends paid on MCI group common stock	—	—	(71)
Advances (to) from WorldCom group, net	(2,097)	(1,592)	15
Net cash used in financing activities	<u>(2,097)</u>	<u>(1,592)</u>	<u>(551)</u>
Net increase (decrease) in cash and cash equivalents	46	(29)	(34)
Cash and cash equivalents at beginning of period	24	70	41
Cash and cash equivalents at end of period	<u>\$ 70</u>	<u>\$ 41</u>	<u>\$ 7</u>

The accompanying notes are an integral part of these combined statements